Andy Xie: What We Can Learn as Japan's Economy Sinks

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Japan hasn't sustained growth bounces for decades, nor will it under the DPJ government. Therein lie lessons for other economies.

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(*Caijing Magazine*) Japan has had a political earthquake. The Liberal Democratic Party (LDP) that ruled Japan since the end of the World War II lost most of its seats in the latest election, while the Democratic Party of Japan (DPJ) won 308 of 480 lower house seats, complementing its majority in the upper house.

Now, DPJ is in a strong position to undertake structural reforms. Indeed, a big political change brings hope in any country that's stagnated for as long as Japan. However, DPJ is unlikely to turn around Japan's economy anytime soon. LDP, in the name of Keynesian stimulus, spent all its money over the past decade on wasteful investments, leaving DPJ with no resources for reform. I'm afraid DPJ has an impossible situation on its hands.

Anyone who doesn't believe in the harm of a financial bubble but does believe in Keynesian stimulus magic should visit Japan. A likely dip for the Anglo-Saxon economies next year will underscore these truths. The same goes for anyone who thinks China's latest real estate bubble, asset borrowing and shadow banking system are worthwhile substitutes for real economic growth.

The world including China can learn a lot by looking at what's happened to Japan, and what's in store for DPJ. Since Japan's stock market bubble burst in 1989 and the land market popped in 1992, the LDP government has run up debt equal to nearly 200 percent GDP in hopes of reviving the economy. And its economy has stagnated.

The burst of the global credit bubble in 2008 brought down Japan's export machine. That was its only hope. Now, of all OECD economies, Japan's looks most like a depression. Its nominal GDP declined 8 percent in the first quarter 2009 from the year before. Although its economy rebounded a bit in the second quarter, nominal GDP for 2009 is still expected to decline substantially and will likely be lower than in 1993.

Many analysts blame Japan's problems on corporate inefficiency. This is partly true. Japan has had a hyper-competitive export sector. Domestic, demand-oriented industries are inefficient due to labor market practices. More importantly, sectors that became massively levered during the bubble years have been walking like zombies for two decades, weighing down the economy's overall efficiency. Japan's inefficiencies are largely a consequence of its decision to prop these industries.

U.S. return on asset (ROA) was twice as high as that in Japan. But, in hindsight, higher ROA in the United States was mostly a bubble phenomenon. Much of U.S. corporate profitability was due to financial engineering. In one aspect, the export

performance of Japan's corporate sector has done very well -- much better than its U.S. counterpart. Japan's exports doubled in yen terms between 1993 and 2008, and the sector's share of GDP nearly doubled to 16 percent from 9 percent, even though the yen remained strong during the period. The performance of Japan's export sector shows its inefficiencies elsewhere were largely due to shortcomings in the system.

Japan's stagnation has been linked to government handling of debt overhang in the corporate sector -- mainly in the real estate, construction, and retail sectors, and left over from the bubble era. In the 1980s, especially after the Plaza Accord, Japan's corporate sector accumulated a massive amount of debt for financial speculation. Total corporate debt more than doubled to about 900 trillion yen, or 200 percent of GDP, from 1984-'92. After land and stock prices collapsed, the net value of the corporate sector's financial assets switched from about 30 percent of GDP to a minus 50 percent of GDP. If the change in land holding value is included, the corporate sector's net worth may have fallen by 200 percent of GDP. As corporate profits are about 10 percent of GDP in a developed economy, Japan's corporate sector would need two decades to earn its way back.

The Japanese government did choose to let the corporate sector earn its way back, first by preventing bankruptcies and second by stimulating demand. To achieve the first goal, the government kept interest rates near zero and Japanese banks did not pursue mark-to-market accounting in assessing borrower solvency. With a big chunk of the corporate sector zombie-like, the economy, of course, was always facing downward pressure. The government had to run large fiscal deficits to prop up the economy. After the bubble, Japan's economic equilibrium stagnated and the fiscal deficit swelled.

This strategy was flawed in three aspects. First, even as the corporate sector earns profits to pay down debt, the government's debt is rising. At best, it is shifting corporate debt to government debt. In reality, government debt has been rising faster than private sector debt has been falling.

Second, economic efficiencies don't increase in such equilibrium. Existing resources in the zombie sector are essentially unproductive. Bankruptcies improve efficiency by shifting resources from failing to succeeding companies. When rules are changed to stop bankruptcies, efficiency is sacrificed. Worse, incremental resources are sucked up to pay fiscal deficits used to prop up zombie industries. Japan is thus trapped in equilibrium of low productivity.

Third, a long period of stagnation could worsen irreversible social change. A falling birth rate, for example, is one consequence that is wreaking havoc on the Japanese economy. Japan's post-bubble policy was to let property prices decline gradually. Hence, living costs also declined gradually. On the other hand, the economy stopped growing, which caused income expectations to quickly adjust downward. The combination of high property prices and low income growth rapidly pushed down Japan's birth rate. As a consequence, Japan's population is declining two decades after the bubble. The rising burden of caring for the old will lower Japan's ability to pay for anything else.

After two decades, Japan hasn't achieved its main policy goal by letting its corporate sector work down debt. Total, non-financial corporate debt is about the same as it was two decades ago. At 180 percent of GDP, Japan's corporate indebtedness remains one of the highest in the world. Japan's household sector has indeed de-levered. Its debt at 69 percent of GDP is one of the lowest among

developed economies. But government debt has increased massively over the past two decades. Its current debt level at 194 percent is the highest in the world. Only super-low interest rates are hiding the debt burden.

DPJ has been handed a poisoned chalice. It won't have the resources needed for a serious restructuring of the economy. Its twin goals are to increase support for the household sector and shift decision-making power to politicians from bureaucrats. The government's debt burden makes it impossible for any meaningful increase in supporting the household sector. LDP wasted all the money. DPJ has no room to finance either new social programs or economic restructuring. To show progress, DPJ is likely to stage a high-profile confrontation with the bureaucracy – a step that may be good for politics but won't do much to improve the economy.

Total indebtedness of Japan's non-financial sector is 443 percent -- probably the highest in the world, and far higher than the 240 percent in the United States. A difference is that the United States owes a big chunk of its debt to foreigners, while all of Japan's is carried by its own citizens.

Most analysts think high government debt is bearable as long as a country has enough domestic savings to fund it – a situation Japan has enjoyed. But the future may be different. Japan's declining labor force is decreasing its export ability. At some point, it may begin to run trade and current account deficits. When that happens, Japan's interest rate may rise substantially, which would cause a fiscal crisis. Such a crisis may occur under the DPJ's rule. It could be blamed for a crisis that LDP had been building for two decades.

We can learn much from Japan's experience. The global economy -- mainly the Anglo-Saxon economy -- is facing the consequences of a massive credit bubble. The remedies most governments have embraced are to keep interest rates low and fiscal deficits high. These are the same policies Japan pursued after its bubble burst nearly two decades ago. How today's bubble economies are treating bankruptcies and bad debt is shockingly similar to what was seen in Japan. The United States and others have suspended mark-to-market accounting rules to let banks stay afloat despite large amounts of toxic assets. It's the same "let them earn their way back" strategy that Japan pursued. The strategy fails to work because it keeps an economy weak, limiting the earning power of financial institutions.

As the global economy is again showing signs of growth in the third quarter, most governments are celebrating the effectiveness of their policies. Yet Japan's experience forces us to pause: Its economy experienced many such growth bounces over the past two decades, but was unable to sustain any of them. The problem was Japan only used stimulus, not restructuring, to cope with the bursting of its bubble. After the demise of any big bubble, serious structural problems that hamper economic growth remain. Stimulus can only provide short-term support that makes structural reform possible. When policymakers celebrate the short-term impact of stimulus and forget structural reforms, economies slump again. I think the Anglo-Saxon economies will dip again next year.

China can learn a lot from Japan's experience as well. Its bubble formed when companies began focusing on financial investments rather than core business. In the 1980s, Japan's corporate sector tapped the corporate bond market and raised massive amounts of capital for asset purchases.

Recently, Chinese enterprises borrowed money and pumped it into asset markets. They essentially provided leverage for asset markets. When leverage was rising,

asset inflation occurred, letting companies book profits that were many times greater than operating profits from core businesses. That gave them greater incentive to pursue asset appreciation rather than operating profitability. The corporate sector became a shadow banking system for financing asset speculation.

Thus, China's corporate sector is now behaving in a way similar to what was seen in Japan two decades ago. China's businesses increasingly focus on asset investment rather than core business. When an asset bubble boosts corporate profits, it seems benign at first. Nobody sees the harm. However, when businesses earn profits from the investments in each other rather than their corporate businesses, their operating profitability deteriorates because they don't invest in their core businesses anymore. Accounting profitability is just a bubble.

As I traveled across China recently, it was rare to hear about a business whose officials are enthusiastic about their core business. But everyone seems excited about financial activities. The lending boom in the first half of 2009 seems to have been channeled mostly into asset markets by the corporate sector.

In particular, property seems to have become a main profit source for most big businesses. China's corporate borrowing one way or another goes into the land market. And property development has become the most important source of profit for China's corporate sector. If a manufacturing business is buoyant, odds are it is profiting from property development. The banking sector reports high profitability due to direct or indirect loans for property development. Property development profit is actually from land appreciation. If property development profitability is measured according to land price at sale time, the development itself would not be profitable.

A bubble rises when there is excess money supply. Is the current, excessive monetary growth due to demand or supply? We can argue that point forever. When the former chairman of the U.S. Federal Reserve, Alan Greenspan, said a central bank couldn't stop a bubble, he meant money demand would rise regardless of interest rates. I disagree. If a central bank targets monetary growth in line with nominal GDP growth, a big bubble can't happen. Aside from central bank failure, then, the most important microeconomic element in a bubble is the shadow banking system.

Regulators limit what banks can do by imposing capital requirements. The international standard is 8 percent of total assets, but banks can use accounting tricks to minimize their requirements. But a big accounting loophole can lead to disaster. For example, the loose restrictions on off-balance holdings were major factors in the global credit bubble. Most regulators are now tightening accounting rules for capital requirements.

Shadow banking is a less noticed but more important factor in creating bubbles. Most analysts compare it to the hedge fund industry, which provided leverage for financial speculators with little capital. The shadow banking system is much more because industrial firms engaging in financial activities are more important. Entities such as GE Capital and GMAC provided massive leverage to asset markets with little capital. A shadow banking system is essential to a big bubble.

China's corporate sector increasingly looks like a shadow banking system. It raises funds from banks, through commercial bills or the corporate bond market, and then channels the funds into the land market. The resulting land inflation underwrites corporate profitability and improves their creditworthiness in the short term.

The same thing happened in Japan.

To control China's expanding real estate bubble, the country's regulators must limit monetary growth to nominal GDP growth. Faster monetary growth accommodates and supports the bubble. To understand consequences of ignoring this reality, we need only look at Japan today.

Full article in Chinese: *http://magazine.caijing.com.cn/2009-09-13/110248537.html*

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